BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ARCO Products Company, Mobil Oil Corporation, Texaco Refining and Marketing, Inc., and Equilon Enterprises, LLC, Complainants, vs. Santa Fe Pacific Pipeline, L.P., Defendant.	)	C. 97-04-025
And Related Matters.	)	C. 00-04-013
	)	A. 00-03-044
	)	A. 03-02-027
	)	A. 04-11-017
	)	A. 06-01-015
	)	A. 06-08-028
	)	C. 06-12-031

CONCURRENT REPLY BRIEF OF SFPP, L.P.

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TABLE OF CONTENTS

TABLE OF CONTENTS
(continued)

Page

TABLE OF AUTHORITIES

Page(s)

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CONCURRENT REPLY BRIEF OF SFPP, L.P.

In accordance with the procedural schedule established by the presiding administrative law judge ("ALJ"), SFPP, L.P. ("SFPP") hereby respectfully submits its Concurrent Reply Brief in A. 03-02s-027, responding to the initial briefs of (i) BP West Coast Products LLC and ExxonMobil Oil Corporation (herein together referred to as "Indicated Shippers"); (ii) Tesoro Refining and Marketing Company ("Tesoro"); and (iii) ConocoPhillips Company, Chevron Products Company, Ultramar Inc. and Valero Marketing and Supply Company (herein jointly referred to as "CCUV").[1]

[1] By e-mail dated April 9, 2007, ALJ Long extended the date for filing of opening and reply briefs in these consolidated proceedings from April 16, 2007 to April 26, 2007 and from May 7, 2007 to May 17, 2007, respectively.

I. INTRODUCTION

Of the opening briefs filed by the various shipper groups, only the submittal of CCUV substantively addresses matters that are actually before the Commission and relevant to its consideration of A. 03-02-027. The opening briefs filed respectively by Indicated Shippers and Tesoro require limited response given that the majority of their various points and arguments are either superfluous or quite clearly beyond the scope of the subject proceeding or both.

There is only issue raised by Indicated Shippers that is arguably relevant: the propriety of relying on a proxy group comprised of Master Limited Partnerships ("MLPs") in developing the return on equity component of SFPP's Test Year ("TY") 2003 cost-of-service showing. As described more fully below, Indicated Shippers' witness himself relied upon MLPs as the appropriate proxy group for developing a recommended return on equity for SFPP. Now comes counsel for Indicated Shippers, in direct repudiation of the approach sponsored by its own witness, attempting to resurrect an argument, first raised post-hearing, that MLPs should be excluded from the proxy group used to determine an appropriate return on equity for SFPP. Indicated Shippers, however, can cite no relevant basis in the record for establishing SFPP's recommended return on equity without reference to the MLP proxy group given that both showings of SFPP and Indicated Shippers base their respective return on equity recommendation on an analysis of a proxy group of publicly-traded entities that includes MLPs.[2] Consequently, counsel's arguments in this regard, while suffering from vagueness and lack of merit in their own right, also conflict with all evidence of record, including testimony sponsored by Indicated

[2] CCUV Initial Brief at 42.

Shippers, and should be given no consideration.

The remaining matters discussed in Indicated Shippers' opening brief require no response. Indicated Shippers readily acknowledge that their so-called "additional issues to be raised …in cost-of-service cases after 2003," including related discussions of "capital structure" and "ADIT," have nothing to do with the pending proceeding and can be ignored.[3] SFPP is in full agreement with Indicated Shippers in this regard.

Tesoro is even less successful than Indicated Shippers in presenting relevant arguments for the Commission's consideration in A. 03-02-027. While contending that SFPP's electricity surcharge is unreasonable, Tesoro cites no relevant evidence of record in A. 03-02-027 but instead relies improperly upon extra-record information, in the form of an unexamined affidavit submitted in Tesoro's pending complaint case, C. 06-12-031, as a putative basis for adjusting SFPP's TY 2003 cost of service. Its argument that all of the rates collected by SFPP since issuance of Resolution O-0043, and not just the electricity surcharges, are at issue merely because the surcharge is part of SFPP's overall rates is as illogical as it is specious and directly conflicts with the express directive of Resolution O-0043. Tesoro's attempt to equate SFPP's electricity surcharges with SFPP's overall rates is unreasonable on its face.

It is equally irrational for Tesoro to contend, without elaboration, that SFPP's rates are unjust and unreasonable because they do not reflect actual costs. The Commission does not evaluate the reasonableness of utility rates based upon actual, i.e. historical or recorded, costs. As Tesoro itself acknowledges, the Commission uses "projections of future costs – a future test year" – to evaluate whether the revenue to be collected from customers under

[3] Indicated Shippers' Initial Brief at 5.

proposed rates would cover the utility's costs.[4] No further consideration need be given to Tesoro's curious but false misapprehension about the relevance of actual costs in evaluating the reasonableness of SFPP's rates.

The remainder of Tesoro's initial briefing is devoted to matters relating to C. 06-12-031, including responses to affirmative defenses raised by SFPP in its answer to the complaint. The irrelevance of such arguments to the matters at issue in the subject proceeding is quite apparent and establishes that no response is required.

Turning to the initial submittal of CCUV, SFPP will show, in more specific detail below, that CCUV's brief reflects the following deficiencies: (1) it misapprehends the scope of the subject proceeding in arguing that all of SFPP's rates collected since October 24, 2002 are subject to refund; (2) its challenge to the reasonableness SFPP's electricity surcharge elevates form over substance and cites no evidence suggesting that SFPP did not experience increased power costs consistent with the increases forecasted in Advice Letter 14; (3) in arguing that only project costs incurred in calendar year 2003 are includable in Test Year ("TY") 2003, it contradicts well-settled principles of test year ratemaking endorsed by the California Supreme court; (4) in recommending no tax allowance for SFPP, it mistakenly relies on an inapposite court decision, ignores policy statements of both the Commission and FERC which support a tax allowance, and unlawfully seeks retroactive applicability of its proposed change in tax allowance policy; (5) in recommending Commission adoption of various components of SFPP's TY 2003 cost of service, it relies improperly and extensively upon information that is either outside the record in A. 03-02-027 or irrelevant; and (6) it cites not one thread of evidence warranting the establishment of cost-based rates for Watson Station and Sepulveda.

[4] Tesoro Initial Brief at 9.

II. SFPP REPLY ARGUMENTS

A. SFPP RESPONSE TO ARGUMENTS OF INDICATED SHIPPERS

Indicated Shippers tilt at imaginary windmills when they anticipate argument by SFPP in the subject proceeding that the Test Year 2003 cost-of-service case should be discarded and that its pending request in A. 00-03-044 for market-based rates should be approved. SFPP recognizes that TY 2003 cost-of-service is the principal basis established by the Commission for evaluating the reasonableness of electricity surcharge revenues collected since October 24, 2002 and for establishing a basis for setting SFPP's rates on a forward-going basis. However, to the extent there is any issue regarding the reasonableness of the individual rates charged for services related to SFPP's Watson Station and Sepulveda facilities (remaining once the Commission has evaluated SFPP's TY 2003 cost of service), market-based factors are entirely relevant to, if not dispositive of, the Commission's determination of reasonable rates for such services.

As for the one argument of Indicated Shippers that is arguably relevant to the subject proceedings, there is no reason for the Commission to exclude MLPs from the proxy group used to determine an appropriate TY 2003 return on equity for SFPP, much less any record evidence upon which the Commission could adopt a recommended return on equity based upon consideration of a proxy group that does not include MLPs.

Indicated Shippers sponsored testimony recommending a return on equity based upon an analysis of the same five proxy entities, all of which are oil pipeline MLPs, that were relied upon by SFPP's witness in formulating his recommended return on equity.[5] Thus, all of the evidence of record regarding recommended return on equity reflects use of a proxy group that includes MLPs. Indicated Shippers, now at odds with their CCUV colleagues, are "adamant

[5] CCUV Initial Brief at 43.

that the MLPs should be excluded from the proxy group."[6] There is, however, neither a record upon which to do as Indicated Shippers ask nor any intelligible argument why such a course of action is warranted.

Indicated Shippers challenge inclusion of MLPs in the proxy group based upon the apparent significance of an initial distinction between dividends paid by corporations and cash distributions paid by MLPs to their investors followed by an esoteric, albeit misplaced, effort to further differentiate dividends from distributions as a return on equity rather than a return of equity. Indicated Shippers raise a theoretical and obscure objection to inclusion of MLPs in the proxy group for evaluating return on equity, yet they present no viable alternative to evaluating the cost of equity for the MLP, KMEP, which owns and provides required capital to SFPP. In that regard, while liberally citing to FERC decisions as putative support for Indicated Shippers' efforts to make much of the distinction between "return on" and "return of" equity, the Indicated Shippers ignore the following FERC determination regarding use of MLPs in deriving a rate of return on equity:

> there is no practical alternative to treating distributions as the equivalent of dividends and using distributions in the conventional discounted case flow (DCF) formula…the distributions are what investors use to determine the capitalized value of the publicly traded limited partnership interests.[7]

Indicated Shippers' objection to the inclusion of MLPs in the proxy group used to evaluate the appropriate return on equity for SFPP is without support or merit. There is no return on equity recommendation of record that is relevant to SFPP's pipeline operations that does not rely upon a proxy group including MLPs. Nor have Indicated Shippers provided any alternative

[6] Indicated Shippers' Initial Brief at 3.
[7] *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 77 n. 104 (2005).

for evaluating return on equity for SFPP without reference to a proxy group comprised of MLPs.

B. SFPP RESPONSE TO ARGUMENTS OF CCUV

(1) Scope of the Proceeding

While improperly asking the presiding ALJ and Commission to revise the electricity surcharge refund date established in Resolution O-0043, CCUV nevertheless do acknowledge that the appropriate refund period pertaining to electricity surcharges dates from October 24, 2002.[8] CCUV, however, misreads Resolution O-0043 and ignores the Scoping Memo in this proceeding when it asserts that it is SFPP's total rates as of October 24, 2002 that are at issue and subject to refund.[9] It is only revenues related to the electricity surcharge and potentially revenues related to the Watson Station and Sepulveda charges that are at issue in the subject proceeding.

Resolution O-0043 expressly addresses the electricity surcharges established in conjunction with SFPP's filing of its Advice Letter No. 14, stating that "[w]e will limit the issue here to SFPP's request in AL 14."[10] It also addresses, albeit somewhat indirectly, the rates charged for Watson Station and Sepulveda. While the resolution does require the submission of a cost-of-service analysis of Watson Station and Sepulveda, it just as clearly establishes that the cost-of-service analysis will not resolve the issue of whether there is a need for a separate charge for Watson Station and Sepulveda, much less whether such rate should be based upon cost of service or market considerations – all of which issues are to be considered in a pending

[8] CCUV Initial Brief at 6.
[9] CCUV also misreads Resolution O-0043 and the Scoping Memo when it asserts that "the analysis of SFPP's rates was to be based on a 2002 and estimated 2003 revenue requirement…" (CCUV Initial Brief at 4). As quite clearly expressed in the Scoping Memo, it is a forecasted 2003 revenue requirement, and not a 2002 revenue requirement, that is relevant to the Commission's consideration of the reasonableness of SFPP's rates.
[10] Resolution O-0043 at 7.

proceeding (C. 97-04-025) other than A. 03-02-027.[11] Specifically, Resolution O-0043 sets forth the basis for evaluating the reasonableness of electricity surcharges collected since October 24, 2002. If the Commission determines that SFPP did not collect revenues in excess of its reasonable 2003 TY cost of service during the period from October, 2002 to December, 2004, as SFPP believes to be the case, then there will be no refund of any portion of electricity surcharge revenues collected. If the Commission were to determine that SFPP overcollected its 2003 TY cost of service by $6 million or less, SFPP would be required to refund the appropriate portion of $6 million in annual electricity surcharges collected between October, 2002 and December, 2004.

The scope of the present proceeding, A. 03-02-027 with respect to potential refunds could not have been more clearly stated than in the ALJ Scoping Memo dated June 26, 2003:

> The scope of the present proceeding, A. 03-02-027, will be limited to whether SFPP should be permitted an electricity surcharge.[12]

(2) <u>Electricity Surcharge Issues</u>

CCUV fails to provide even a shred of evidence demonstrating the unreasonableness of the forecast of increased electricity costs set forth by Advice Letter 14 in support of SFPP's electricity surcharge. CCUV's challenge to the validity of the electricity surcharge does <u>not</u> reflect any evidence that SFPP did not experience significant increases in

[11] Resolution O-0043 at 8.

[12] While potential refunds related to Watson Station and Sepulveda are beyond the scope of A. 03-02-027, SFPP recognizes that pending matters related to Watson Station and Sepulveda have been consolidated with A. 03-02-027. Accordingly, in view of the consolidated record, if the Commission were to determine that SFPP overcollected its 2003 TY cost of service by more than $6 million and if the Commission were further to determine that there should be separate, cost-based (rather than market-based) rates for Watson Station and Sepulveda, then SFPP could be required to refund (for a time period to be determined) some or all of the difference between the rate charged and a cost-based rate.

power costs as forecasted in Advice Letter 14. Rather, CCUV's protest against the electricity surcharge rest solely on the spurious argument that the reasons for SFPP's increase in power costs ended up being different than the reasons initially set forth and anticipated by SFPP in Advice Letter 14.

The evidence of record shows that SFPP's power costs, whether incurred as a bundled customer or a Direct Access customer, did increase by amounts entirely consistent with level of power cost increases forecasted by Advice Letter 14. Direct Access customers were not immunized from the substantial increases in electricity experienced by all Californians as a result of the energy crisis.[13]

While CCUV focuses exclusively on the fact that SFPP switched from bundled service to direct access service, it provides no evidence whatsoever that the switch in customer status caused SFPP to experience power cost increases materially different from those forecasted by Advice Letter 14. Indeed, the only evidence of record in this regard clearly demonstrates that, irrespective of SFPP's status as a bundled service customer or a Direct Access customer, the 59 percent power cost increase anticipated by Advice Letter 14 was entirely reasonable.[14]

CCUV's attempt to elevate form over substance, by arguing that SFPP had a duty to inform the Commission that its increased power costs were incurred as a Direct Access rather than bundled customer, is not only contrary to the facts it runs counter to the law. Irrespective of when SFPP first became liable for payment of the 2.7¢/kWh DA Cost Responsibility Surcharge, as a consequence of enactment of AB 117, all Direct Access customers, including SFPP, were ultimately required to remit to the utilities essentially the same total amount of charges that they

[13] SFPP Concurrent Opening Brief at 13-15.
[14] *Id.*

would have been billed if they had remained bundled utility customers.[15] SFPP did, in fact, end up incurring the increased power costs that Advice Letter 14 anticipated would be experienced by bundled customers.

(3) Rate Base Treatment for the North Line Expansion Project

(a) SPP's TY 2003 cost of service properly includes $88 million in rate base associated with the North Line Expansion Project.

CCUV presents no viable theory for excluding the North Line Expansion Project from the rate base component of SFPP's TY 2003 cost of service. Resolution O-0043 expressly anticipated consideration of an estimated year 2003 cost of service for purposes of evaluating the reasonableness of SFPP's electric surcharge increase.[16] The ALJ Scoping Memo made it quite clear that the TY 2003 cost of service ultimately adopted by the Commission would be applied (i) to evaluate the reasonableness of annual electricity surcharges collected by SFPP from October 24, 2002; and (ii) to establish the reasonable level of SFPP's rates on a forward-going basis:

> The Commission will determine whether SFPP's rates are reasonable based on Test Year 2003 revenue requirement, and that revenue requirement will be applied to see if the requested electric surcharge rate increase was justified from the date of its imposition by Resolution O-0043 **until the adoption of test year 2003 rates.** (emphasis added).

CCUV grasps at straws when it suggests that SFPP mischaracterizes the scope of the proceeding by asserting that the respective references in Resolution O-0043 and the ALJ Scoping Memo to "estimated year 2003 cost of service" and "test year 2003 rates" quite clearly embrace time periods beyond 2003.[17] SFPP's position, rather than being "self-serving" as

[15] *Id.* at 16.
[16] Resolution O-0043 at 7.
[17] CCUV Initial Brief at 54.

suggested by CCUV, is supported, if not mandated, by California law.

The test period for the subject proceeding is indisputably Year 2003. Test period results will not only be used to evaluate the reasonableness of past SFPP electricity surcharges but will also be applied to establish reasonable rate levels for SFPP on a forward-going basis. In *Pacific Telephone and Telegraph Company v. Public Utilities Commission,* (1965) 62 Cal.2d 634, the California Supreme Court established that test period results properly reflect costs and conditions expected to occur during the twelve months of the test year (2003) as well as reasonably anticipated changes in gross revenues, expenses or other conditions, which do not necessarily obtain throughout the twelve months of the test period but which are reasonably expected to prevail during the future period.

While some portion of the $88 million in costs associated with SFPP's North Line Expansion was not to be incurred in calendar year 2003, it was reasonably anticipated that all of such costs would be incurred by the end of 2004.[18] As such, the law is quite clear that SFPP's TY 2003 rate base should properly reflect North Line Expansion costs in their entirety. The uncontroverted evidence of record shows that planning and construction of the North Line Expansion was underway in 2003, with every reasonable expectation that the project would be completed in 2004.

CCUV's attempt to distinguish the subject situation from that addressed in *Pacific Telephone* is unavailing.[19] As was exactly the case in *Pacific Telephone,* the Commission, in the subject proceeding, will be evaluating test year results for purposes of reviewing the

[18] The witness for Indicated Shippers presented no facts contesting the validity of either the forecasted project completion date or the project's estimated cost of $88 million. Rather, his basis for characterizing the North Line Expansion as "speculative" involved nothing more than the fact that project completion was, at the time of his testimony, some twelve months' in the future. (See Tr. Vol. 4; O'Loughlin at 470-471).

[19] CCUV Initial Brief at 55.

reasonableness of existing rates and establishing future or forward-looking rates.

In what amounts to an implicit concession that SFPP's proposed, full rate base treatment of the North Line Expansion Project is correct, CCUV resorts to a fall-back position that would have the Commission only allow $65.2 million or 62% of the claimed North Line expansion rate base of $88 million.[20] CCUV has no valid factual, legal, or policy reason for supporting its arbitrary recommendation. The Commission's determination of amounts properly included in SFPP's TY 2003 rate base is governed by *Pacific Telephone* rather than by a subsequent rate increase filing, as suggested by CCUV. Matters at issue in A. 04-11-017, in which SFPP seeks to justify a $9 million rate increase (as of December, 2004) based upon a forecast showing that it is underearning its cost of service by $14.3 million, simply are not pertinent to the Commission's resolution of SFPP's TY 2003 cost of service. SFPP fully recognizes that the Commission's ultimate determination of SFPP's TY 2003 cost of service will necessarily be relevant to the Commission's subsequent review and consideration of A. 04-11-017. SFPP also understand that, to the extent that A. 04-11-017 involves an increase in revenue requirement above the Commission's adopted TY 2003 revenue requirement for SFPP, any portion of North Line Expansion Project rate base that is properly included in the Commission's adopted TY 2003 cost of service cannot be used by SFPP to justify any incremental revenue requirement at issue in A. 04-11-017. There is, however, neither need nor justification for Commission adoption of CCUV's recommendation to only include $65.2 million of North Line Expansion costs in SFPP's TY 2003 rate base.[21]

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[20] *Id.* at 58.

[21] CCUV will have every opportunity in A. 04-11-017 to litigate the issue of whether any portion of rate base associated with the North Line Expansion is arguably being double-counted for purposes of evaluating and establishing SFPP's TY 2003 rates in A. 03-02027 and justifying the $9 million rate increase at issue in A. 04-11-017.

(b) There is no merit to CCUV's criticism of SFPP's proposed TY 2003 rate base adjustments.

In addition to the unwarranted effort to exclude the North Line Expansion from SFPP's Test Year 2003 rate base on the patently false ground that it is too speculative, CCUV advances certain technical, albeit incorrect, criticisms of SFPP's proposed rate base adjustments as they relate to the North Line Expansion. CCUV complains that SFPP has proposed to add the North Line Expansion to its Test Year 2003 rate base while failing "to match a full year of major carrier additions with a full year of accrued depreciation."[22] Even if one were to agree with CCUV that an additional year of depreciation should be deducted from rate base to coincide with the then- anticipated 2004 in-service date of the North Line Expansion, the appropriate adjustment then would be to do just that – reduce rate base for another year of depreciation rather than use this alleged "failure" as an excuse to eliminate the North Line expansion altogether from the test year

However, including another year of depreciation is not an appropriate adjustment, as SFPP's witness explained during cross-examination, because it would create an "Estimated 2004" cost of service while the Commission's Resolution expressly required an "Estimated 2003" cost of service.[23] CCUV fails to understand that in test year ratemaking there is crucial difference between properly adjusting the test year forecast to reflect a new category of costs not incurred in the test period but reasonably expected to be incurred within the immediate months beyond the test period as opposed to improperly reflecting, as CCUV suggests, twenty-four, rather than twelve, months of the same category of expense(e.g. depreciation) in the test year period.

[22] CCUV Initial Brief at 53-55.
[23] Tr. Vol. 3; Turner at 336.

SFPP's witness further explained that in developing rate base for the Test Year 2003, he included the 2003 budgeted capital projects, which includes funds for the North Line Expansion project – the only 2003 project slated to be completed in 2004 – rather than a whole-sale inclusion of 2003 and 2004 capital budgeted projects.[24] Indeed, had SFPP's witness prepared a rate base through 2004 as CCUV claims he should have, then he simply would have been subject to criticism for violating the requirements of the Resolution O-0043 to develop an "Estimated 2003" cost of service and for double counting the same category of expense.

(4) Federal Income Tax Allowance

(a) Fairness as well as other policy and legal considerations require continued inclusion of a full tax allowance in SFPP's cost of service.

D. 99-06-093 (the "Rehearing Decision) issued in C. 97-04-025 succinctly frames the tax issues requiring further consideration: (i) whether the Commission should adopt the approach endorsed by FERC in *Lakehead Pipeline Co.* (1996) 75 F.E.R.C. ¶ 61,181 of looking to the tax situations of the owners of a limited partnership rather than imputing a tax allowance at the corporate rate; and (ii) whether alternative approaches to tax allowances for limited partnerships, including the FERC approach, are consistent with the *Southern Cal. Gas* line of cases.[25]

Given that the *Lakehead* approach has been found to be legally deficient and is no longer endorsed by the FERC, the one alternative to a full tax allowance identified in the Rehearing Decision, i.e. *Lakehead* treatment, has been effectively eliminated from Commission consideration. The Rehearing Decision further demonstrates that complete elimination of the tax allowance for SFPP, as proposed by CCUV is not one of the alternative approaches worthy of

[24] *Id.*, at 331-332.
[25] CPUC Decision 99-06-093, 1999 Cal. PUC LEXIS 442.

Commission consideration.

In D. 99-06-093, the Commission expressly dismissed the same, simplistic argument repeatedly advanced by CCUV asserting that SFPP is not entitled to a tax allowance because it does not itself pay income taxes. First, the Commission acknowledged that tax allowances for utility partnerships are permissible under the *Southern Cal. Gas* line of cases, recognizing that the key factor is whether utility distributions to their investors are ultimately subject to taxation and not whether or what amount of taxes are paid by the utility itself:

> Contrary to the [complainants'] claims, we do not believe the relevant cases prevent this result. In Income Tax Expenses for Ratemaking Purposes (1984) 15 Cal.P.U.C.2d 42, we adopted a similar approach for utilities filing consolidated returns with non-utilities. In such cases, the utility's actual tax was affected by the performance of affiliate entities. We determined the correct approach was to assume that the utility would pay tax on a stand-alone basis and use that amount of tax to set rates. We rejected the contention that the allowance for income tax be determined using the best estimate of tax actually paid. (15 Cal.P.U.C.2d 49.) The key factor in the court cases appears to be the effect of tax consequences on the rate of return. Where tax consequences have the effect of reducing the rate of return, it may well be permissible to raise that return.[26]

Secondly, the Commission specifically rejected the sole premise of CCUV's tax disallowance argument, i.e. that SFPP is not entitled to a tax allowance simply because it does not itself pay income taxes. The Commission has made it quite clear that the fact that SFPP itself does not pay income taxes is not even necessarily relevant to the determination of the level of tax allowance to which SFPP is entitled, much less determinative of SFPP's right to any such tax allowance:

> SFPP itself does not in fact pay tax on the income it generates. This is because SFPP is organized as a limited partnership. [footnote omitted] However, this does not mean that income generated by SFPP is tax-free. The income SFPP generates is taxable in the hands of SFPP's owners, regardless of the amount of cash SFPP actually distributes to them. The amount of tax paid on income SFPP generates depends on the tax situation of each of its owners – including the possibility that the tax

[26] CPUC Decision 99-06-093, 1999 Cal. PUC LEXIS 442, *4-5.

> obligation may be passed on to a further, indirect owner of SFPP or, ultimately, that the income might be non-taxable.
>
> Unfortunately, SFPP has a complex ownership structure, making it extremely difficult to determine how much tax is paid on the income it generates, and by whom. SFPP's ultimate owners are removed from the actual operating utility and ownership interests trade on the NYSE. If we assume that no tax will be paid on income generated by SFPP when we establish its rate of return, we will run the risk that for some owners, we will have effectively reduced their rate of return.[27]

That leaves CCUV's recommendation to exclude any tax allowance from SFPP's cost of service resting upon the factually and legally incorrect assertion that income earned by SFPP is not subject to taxation at any of SFPP's ownership levels.[28] The Rehearing Decision itself, while recognizing the difficulty in determining how much tax is paid on income generated by SFPP given that tax liability is dependent on each individual investor's tax status, implicitly acknowledges that some indeterminate number of SFPP's owners are subject to actual or potential income tax liability. Furthermore, SFPP presented evidence demonstrating that its income is quite obviously subject to taxation.[29] It is therefore nonsense for CCUV to argue that SFPP is not entitled to any tax allowance because it has not met its burden of proving how much tax is paid on the income it generates and by whom.[30] SFPP was not required to present evidence to support a *Lakehead* approach to tax allowances. Instead, SFPP favors continuation of Commission policy providing for a full income tax allowance and has more than met its burden of demonstrating the legal and policy considerations which favor just such an approach, including the fact that SFPP's owners are subject to actual or potential tax liability with respect to income and distributions attributable to SFPP's public utility operations.

The Commission's position is quite clear that neither the amount of taxes actually

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[27] *Id.*, *5.
[28] CCUV Initial Brief at 27.
[29] SFPP Ex. 206(R) at 2-4).
[30] CCUV Initial Brief at 27.

paid by a utility nor the amount estimated to be actually paid by the utility is the determinant of the utility's tax expense allowance. Essentially, the amount of taxes actually paid by SFPP itself is irrelevant to the Commission's determination of a proper income tax expense allowance for SFPP. It is obvious that a utility that pays no taxes and that earns income that is not subject to taxation is not entitled to any tax allowance. That, of course, is not the subject situation given evidence that SFPP's income is quite clearly subject to taxation.[31]

(1) The D.C. Circuit Court decision repudiating the FERC's *Lakehead* approach to tax allowances is not relevant to, much less dispositive of, the Commission's determination of a tax allowance policy applicable to SFPP's California public utility operations.

SFPP does not believe that it is useful or appropriate to engage in protracted argument about the scope and effect of the D.C. Circuit opinion in *BP West Coast Products, L.L.C. v. FERC*, 374 F. 3d 1263 (D.C.Cir.2004) ("*BP West Coast*"). It is sufficient to note that SFPP, as well as the FERC, dispute CCUV's assertion that *BP West Coast* establishes as a matter of federal law that "a publicly traded limited partnership pipeline paying no income taxes is not entitled to an allowance for non-existent income tax expenses – regardless of the fact that the unitholders that invested in the pipeline are potentially liable for income taxes on their income, if any, attributable to the pipeline."[32] Indeed, as referenced more specifically below, subsequent to the issuance of *BP West Coast*, the FERC, in full consideration of the import of the D.C. Circuit order, specifically adopted a tax allowance policy for limited partnerships that provides for a tax allowance to the extent that unitholders in the pipeline partnerships are subject

[31] The Rehearing Decision references the difficulty of quantifying the amount of tax paid on income generated by SFPP because, among other things, there is the possibility that as income is passed on to indirect owners of SFPP it might ultimately be non-taxable. (D. 96-06-093, mimeo. at 6, fn. 4). SFPP is unaware of the circumstances in which this eventuality might occur. As SFPP's witness noted: "Under the unrelated business taxable income rules of the Code, even tax exempt entities are subject to taxation on income from a publicly traded partnership. (SFPP Ex. 206(R) at 2).

[32] CCUV Initial Brief at 33.

to actual or potential tax liability on income attributable to the partnership.

BP West Coast held that the FERC had not justified the so-called *Lakehead* policy. It does not hold, as CCUV suggests, that a partnership cannot be afforded a tax allowance because it does not pay taxes. Even if one were to accept CCUV's characterization of the holding in *BP West Coast*, it has no applicability to the Commission's development of ratemaking policies consistent with the requirements of California law. *BP West Coast* addresses itself to the lawfulness, under federal law, of the FERC's rationale for providing SFPP with a partial income tax allowance under the FERC's *Lakehead* policy. As such, the legal analysis and rationale of *BP West Coast* concentrates on the specific deficiencies of the *Lakehead* policy in the context of applicable federal law.[33] *BP West Coast* did not review the lawfulness of the FERC's pre-*Lakehead* policy providing for a full income tax allowance for pipeline partnerships, nor does it, for obvious reasons, address the FERC's subsequent, post-*Lakehead* action in reinstituting a full income tax allowance for partnerships to the extent that it can be demonstrated that partnership unitholders are subject to actual or potential liability on income attributable to the partnership.

Of course, the Commission's income tax allowance policy currently applicable to SFPP is not based on the *Lakehead* approach and therefore does not suffer from any of the legal deficiencies identified by the circuit court in *BP West Coast*. Furthermore, the circuit court's explication of federal law as it relates to FERC's *Lakehead* policy approach has no bearing upon the Commission's exercise of its statutory ratemaking authority under California law or its discretion to establish tax allowance policies consistent with California law.

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[33] Specifically, the D.C. Circuit rejected the FERC's stated rationales for its *Lakehead* policy, including (1) the double taxation of corporate earnings; (2) the equalization of returns between different tpes of

(footnote continued)

(2) The FERC *Policy Statement on Income Tax Allowance* further validates existing Commission policy favoring a full income tax allowance for SFPP.

In response to *BP West Coast,* the FERC issued its *Policy Statement on Income Tax Allowance (*"*Policy Statement* ") expressly reversing the income tax allowance holdings of its earlier *Lakehead* orders and concluding:

> . . . that it should return to its pre-*Lakehead* policy and permit an income tax allowance for all entities or individuals owning public utility assets, provided that an entity or individual has an actual or potential income tax liability to be paid on that income from those assets.[34]

While the Commission is no more bound by the FERC's policy statement than it is bound by *BP West Coast*, it is noteworthy that the policy considerations which prompted the FERC to favor tax allowance treatment for partnerships are entirely consistent and consonant with existing Commission policy regarding treatment of utility income tax allowances. As a reason for returning to its pre-*Lakehead* policy, the FERC rejected the relevance of the fact that the utility partnership/pass-through entity pays no cash taxes itself and instead focused on the fact that the owners of a pass-through entity pay income taxes on the utility income generated by the assets they own via the device of the pass-through entity. In FERC's view, the taxes paid by the owners of the pass-through entity are just as much a cost of acquiring and operating the assets of the entity as if the utility assets were owned by a corporation. FERC further noted that the return to the owners of pass-through entities will be reduced below that of a corporation investing in the same asset if such entities are not afforded an income tax allowance on their public utility income.[35]

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public held interests, and (3) encouraging capital formation. (See SFPP Concurrent Opening Brief, Attachment A at 1-2).

[34] 111 FERC ¶ 61,139 (2005) at P 33.

[35] SFPP Concurrent Opening Brief, Attachment A at 2.

The FERC's rationale for a tax allowance for partnerships as set forth in the *Policy Statement* is identical, if not strikingly similar, to the rationale for providing a tax allowance to a pass-through entity that itself does not pay taxes that was expressed by the Commission in its Rehearing Decision:

> SFPP itself does not in fact pay tax on the income it generates…this does not mean that income generated by SFPP is tax-free. The income SFPP generates is taxable in the hands of SFPP's owners... If we assume that no tax will be paid on income generated by SFPP when we establish its rate of return, we will run the risk that for some owners, **we will have effectively reduced their rate of return.**[36] (emphasis added).

In further support of tax allowance treatment for pass-through entities, the FERC notes that there is no rational reason to limit the income tax allowance to public utility income earned by a corporation. Public utility income controlled directly by an individual may also be taxed. The partnership entity is simply an intermediate ownership device that leads to the same tax result.[37] Finally, the FERC concluded that the provision of an income tax allowance to partnerships in proportion to the interests owned by entities or individuals with an actual or potential income tax liability does not create a phantom tax liability. An income tax allowance for pass-through entities properly simply recognizes in rates the actual or potential income tax liability ultimately attributable to regulated utility income.

The Commission is free, of course, to establish its own policy regarding tax allowance treatment for partnerships like SFPP. The fact that the FERC after substantial and comprehensive analysis of the issue has essentially adopted a tax allowance policy that mirrors the Commission's previously established policy strongly suggests that there is no reason for the Commission to change.

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[36] CPUC Decision 99-06-093, 1999 Cal. PUC LEXIS 442, *5.
[37] SFPP Concurrent Opening Brief, Attachment A at 16.

While there is ample justification for the existing Commission policy of allowing a full tax allowance for SFPP, including the policy reasons most recently articulated by FERC, denial of an income tax allowance to SFPP, and SFPP alone, as recommended by CCUV would be patently unfair and unreasonable. No regulatory body, state or federal, has adopted the radical policy position advocated by CCUV. The proposal of CCUV to eliminate a tax allowance for SFPP should be rejected out of hand.

(b) Any change in the Commission's policy regarding tax allowances for utility ratemaking purposes could only be applied prospectively to SFPP.

It is important for the Commission to recognize the procedural context in which the tax allowance is now presented for Commission consideration because the procedural posture of the matter dictates that any change, albeit unwarranted, in tax allowance policy for SFPP could only be given effect prospectively. No portion of the electricity surcharges collected since October 24, 2002 that are at issue in A. 03-02-027 are subject to refund based upon a change in tax allowance policy.

The issue of the amount of federal income tax allowance properly includable in SFPP's rates was reserved for consideration by D. 99-06-093 (the "Rehearing Decision") issued in C. 97-04-027. C. 97-04-025, in turn, involves a challenge to the reasonableness of existing SFPP rates that had previously been found reasonable by the Commission. The Commission has described the legal limits on its authority to act in response to a complaint challenging the reasonableness of rates:

> The complainants ask that rates be adjusted and a refund plus interest be paid pack to 1983. Rates are set prospectively, not retroactively…The rates charged today were found reasonable in prior rate proceedings, and even if, as alleged, these rates are today excessive, the Commission cannot grant any retroactive relief in the proceeding (PU Code §734). However, the Commission can and will order the Company to file a general rate application to justify the continuation of

the rates and charges presently in effect.[38]

While C. 97-04-027 has been consolidated with A. 03-02-027, Resolution O-0043 which gave rise to A. 03-02-027 expressly limits the issue to be addressed to SFPP's request in Advice Letter 14 to collect $5.77 million in annual electricity surcharges.[39] Resolution O-0043 only references the income tax allowance issue in describing matters pending in C. 97-04-027 and specifically notes that the issues in pending in C. 97-04-027 and other matters involving SFPP are not germane to the Commission's resolution of the validity of SFPP's electricity surcharge increase.[40] Neither Resolution O-0043 nor the ALJ Scoping Memo establishes that the electricity surcharge revenues at issue in A. 03-02-027 are being collected subject to refund based upon potential Commission change in tax allowance policy for SFPP ordered in C. 97-04-027. Therefore, there can be no refund of electricity surcharge revenues in A. 03-02-027 based upon any change in tax allowance policy that might follow from a decision issued in C. 97-04-027.

Should the Commission, contrary to reason and the record in C. 97-04-027, decide to change tax allowance policy applicable to SFPP, it could either require the filing of a general rate case application or require incorporation of the new tax policy in any of the pending SFPP rate proceedings in which no scoping memo has been issued, including A. 04-11-017, A. 06-01-015, and A. 06-08-028. The Commission could not, however, lawfully require SFPP to refund its electricity surcharges based upon any such change in tax allowance policy. The simple, expedient, and correct thing for the Commission to do is to summarily reject CCUV's proposed treatment of income tax allowances for SFPP.

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[38] *Johnson v. Santa Clarita Water Company*, Decision 96-01-026, 1996 Cal. PUC LEXIS 43, *21.
[39] Resolution O-0043 at 7.
[40] *Id.*

(5) 2003 TY Cost of Service Issues

(a) Purchase Accounting Adjustments ("PAA's") are not relevant to the Commission's determination of SFPP's capital structure or the allocation of G&A expenses for cost-of-service purposes.

SFPP's reflection of a 1998 PAA in recommending its TY 2003 capital structure and in allocating G&A expenses between California-jurisdictional and FERC-jurisdictional operations and between carrier and non-carrier services as part of its TY 2003 cost of service showing is entirely consistent with Commission cost accounting and utility cost-of service development. Whether or not SFPP's TY 2003 treatment of PAA's is inconsistent with FERC-related actions that have occurred subsequent to and well beyond the test-year period in A. 03-02-027, such determinations are not particularly relevant to the Commission's consideration of the reasonableness of SFPP's rates under California law.

Commission regulation of pipeline rates is not predicated upon wholesale incorporation of FERC principles of original cost accounting and utility cost-of-service development. In recognition that pipelines are different from traditional monopoly utilities, the Commission has demonstrated a more flexible approach to pipeline rate review that incorporates consideration of market-based factors along with application of cost-of-service principles. Indeed, the Commission's historical approach to pipeline regulation has not reflected development of a detailed cost-of-service methodology that is remotely similar to the complex cost-of-service methodologies employed by FERC. However, to the extent that the Commission has developed cost-of-service principles applicable to public utility pipelines, as specifically noted below, SFPP's treatment of PAA's in its TY 2003 showing is entirely consistent with such principles.

SFPP takes exception to CCUV's argument that the 1998 PAA unjustly impacts SFPP's estimated 2003 costs of service.[41] Simply put, CCUV's claim that SFPP's cost of service is somehow inflated because of PAA's is nothing more than a red herring. Specifically, all the Commission cases cited by CCUV deal with the issue of original cost with respect to rate base development. SFPP agrees that Commission-adopted, cost-of-service principles require that rate base, comprised primarily of carrier property in service, shall include only the original cost of those assets. Thus, any accounting adjustments resulting from acquisitions of assets already in service or company reorganizations, that may indeed be required for financial reporting purposes, are not appropriate for inclusion in rate base when calculating a regulatory cost of service. This is a well-settled precedent which SFPP acknowledges and which has been incorporated in its development of the cost of service required under Resolution No. O-0043.[42]

The fact is SFPP does not have any costs associated with PAA's in its costs of service. CCUV's proposal to "adjust" SFPP's capital structure and cost allocation formulas to selectively remove PAA's is fundamentally incorrect, disregards the underlying principles of capital structure and cost allocation methodologies. It ignores the reality that the premium paid for acquisition of a utility asset, while not includable in utility rate base, is nevertheless a utility-related cost that must be financed either through debt or equity. It contradicts common sense by implying that the actual amounts paid to acquire different assets is not the best indicator of each asset's respective value to its owner nor the most logical determinant for allocating general corporate overhead between the two assets. The CCUV proposal to selectively exclude PPAs from consideration in SFPP'sTY 2003 cost of service, and not just from rate base as SFPP has

[41] CCUV Initial Brief at 15.
[42] See e.g; Ex. 104A, Turner, at 6-7 and Ex. 105A, Turner, at 21.

done, is nothing more than an arbitrary, self-serving artifice intended to eliminate the inclusion of legitimate utility expenses in SFPP's cost of service.

(b) The record supports adoption of SFPP's rate of return recommendations.

(1) SFPP's TY 2003 assumed cost of debt of 7.08 percent is reasonable.

For TY 2003, SFPP recommends a debt cost of 7.08 percent while CCUV recommends a debt cost of 6.41 percent. The basic difference between the cost-of-debt recommendations of CCUV and SFPP reflects recognition by SFPP's expert witness that certain short-term financing instruments used by KMEP to raise capital involved special purpose financing that could not have been used to finance SFPP. Furthermore, such special purpose, short-term debt instruments do not accurately represent the cost of longer-term debt which is more likely to be the source of debt financing for SFPP throughout the test year period extending beyond 2003.[43] Finally, because debt levels/interest rates attributable to short-term instruments like commercial paper fluctuate constantly, those instruments generally are not useful debt cost indicators for ratemaking purposes. Accordingly, SFPP removed the short-term instruments from its calculation of the long-term debt cost to be imputed to SFPP and concluded that such cost is 7.08%. As such, SFPP's recommendation reflects a more accurate forecast of the cost of KMEP debt financings actually to be used to support future SFPP's operations and therefore should be the cost of debt properly imputed to SFPP.

Contrary to CCUV's argument, actions taken in 2005 either by FERC or a FERC ALJ with respect to specific treatment of some of SFPP's short-term debt have no bearing upon or relevance to Commission determination of SFPP's TY 2003 cost of service. Even if the

[43] Ex. 103A; Williamson at 5.

record were updated to improperly reflect the existence and nature of specific, short-term debt obligations incurred beyond the 2003 test year period, there is no indication whether the short-term financing that was deemed by FERC in 2005 to be the equivalent of long-term debt was (all or in part) devoted to support SFPP's future operations or to special purposes unrelated to SFPP operations. The FERC ALJ decision cited by CCUV has been challenged and has no legal effect. In the absence of any basis in the record of this proceeding for distinguishing between the purposes to which the short-term financing at issue was put, the cited FERC decisions cannot be relied upon to contest SFPP's recommendation to exclude short-term financing from its cost of debt because, among other reasons, the excluded short-term financing was for purposes unrelated to SFPP operations.

(2) SFPP's TY 2003 capital structure based upon an assumed 60-40 equity-to-debt ratio is reasonable.

For TY 2003 SFPP recommends a capital structure consisting of 60 percent equity and 40 percent debt. CCUV's witness in A. 03-02-27 recommends a 44.06%-55.94% equity-to-debt ratio. SFPP's recommended capital structure, forecasted for TY 2003, is reasonably based upon management's commitment to move KMEP's actual capital structure. CCUV, by contrast, swings between a recommended capital structure that improperly relies upon past, recorded debt and equity rather than a forecast of anticipated debt/equity ratio, as set forth in its testimony, and improper reliance on extra-record information reflective of time periods well beyond the 2003 test year period, as argued in its brief.

SFPP will only respond to the CCUV arguments that are based upon the record in A. 03-02-027. CCUV's reliance on recorded numbers gives no consideration to the express commitments of KMEP management to optimize the partnership's capital structure at 60% equity and 40% debt. Nor is there any recognition by CCUV that historically low interest rates

explain why KMEP management would not have had an economic incentive to aggressively reach the targeted mix of 60/40 equity-to-debt or that when interest rates rise, as they inevitably will, KMEP will increasingly turn to equity financing as a source of capital, consistent with the stated goal of achieving a capital structure comprised of 60% equity and 40% debt.

CCUV compounds the problem of basing its capital structure recommendations solely in reliance on historical results by its gratuitous effort to eliminate PAA's from KMEP's equity portion of its capital structure.[44] There are fundamental flaws in CCUV's rationale for manipulating KMEP's capital structure to reflect even more debt than the recorded numbers, causing CCUV to significantly overstate the debt component (55.94%) and understate the equity component (44.06%) in its recommended capital structure.

Specifically, the underlying principle of a capital structure for purposes of calculating a regulatory cost of service is: (i) to forecast the mix of equity and debt that the pipeline company (or its parent, as in SFPP's case) will likely rely on to finance its investments; and (ii) to apply the assumed debt and equity rates of return to the appropriate regulatory rate base components. CCUV, however, provides no rationale whatsoever why its proposed PAA adjustment has anything to do with the intended purpose of establishing a capital structure as a necessary part of the cost-of-service ratemaking process. In addition to the absence of any explanation why it is appropriate to artificially deflate the equity level of KMEP's capital structure while inflating the debt component, CCUV's elimination of the PAA from the equity component assumes that KMEP's acquisition of SFPP was financed entirely by the issuance of equity.

The table below, developed from the published annual reports of KMEP, shows

[44] *Id.*, at 21.

the magnitude of CCUV's erroneous assumption regarding PAA's to be on the order of millions of dollars:

Year Ended	Long Term Debt	Partners' Capital	Debt % of Total	Prime Lending Rate
1997	$146.8	$150.2	49%	8.50%
1998	$611.6	$1,360.7	31%	7.75%
1999	$989.1	$1,774.8	36%	8.50%
2000	$1,255.5	$2,117.1	37%	9.50%
2001	$2,231.6	$3,159.0	41%	5.00%
2002	$3,659.0	$3,416.0	52%	4.25%

The table reflects that in the year KMEP acquired SFPP (1998), its long-term debt increased as well as its partners' capital. The table also reflects the fact that while in an aggressive acquisition mode, KMEP has increased its financing of acquisitions by securing an increased proportion of debt, taking advantage of interest rates while at historic lows. Despite what CCUV would have the Commission believe, the manner in which the PAA's were treated on the books at the SFPP level is irrelevant to determination of the KMEP capital structure to be imputed to SFPP. That is so because once acquired by KMEP, SFPP became a wholly-owned subsidiary, consolidated into the financial statements of the parent company. It is the parent company's financial statements that are indisputably relevant. CCUV's application of a narrowly applied original cost regulatory precedent to eliminate PAA's solely from the equity component of KMEP's capital structure not only disregards the fundamental ratemaking purpose for determining a utility's capital structure, but it also inappropriately assumes that the acquisition of SFPP was financed entirely with the issuance of equity.

(3) SFPP's TY 2003 assumed cost of equity of 15.86 percent is reasonable.

SFPP recommends a TY 2003 return on equity of 15.86 percent while CCUV

recommends a return on equity of 12.8 percent. While CCUV claims to have endorsed the use of a Discounted Cash Flow ("DCF") methodology for developing its recommended return on equity,[45] the record quite clearly reflects that CCUV improperly relies on a discounted income model and not a discounted cash flow model as is the DCF model.[46] The DCF model rests on the fundamental premise that investors are primarily, if not solely, interested in the potential cash return on their investment. It is cash that buys goods and services. Income per share, on the other hand, is an accounting concept - not money. While investors certainly may be interested in reported income per unit, reported income reflects a reporting entry rather than real dollars with which to purchase goods and service.

By relying on the patently false assumption that investors are more interested in an abstract accounting concept ("earnings" or "income") than in tangible cash distributions, CCUV completely bastardizes the DCF model simply in order to understate the return on equity that investors expect when purchasing units in an MLP. Arbitrarily assigned earnings/income figures are substituted for the true cash distributions that should have been inputted in the DCF model, producing the inevitable "garbage in – garbage out" results. "Earnings" are not cash flow. Neither distributions nor investment in company assets are made with earnings. They are made with cash flow. Cash flow and earnings are not synonymous. As the evidence of record indicates, there is no regulatory decision that agrees with CCUV's peculiar, alternative formulation and use of the DCF model to reflect income rather than cash flow.

In their initial brief, CCUV relies extensively on various FERC decisions, asserting that they stand for certain propositions regarding proper use of the DCF model,

[45] CCUV Initial Brief at 42.
[46] SFPP Opening Brief at 40.

including the requirement that distributions used for purposes of a DCF analysis should include only payments reflecting return on investment rather than return of investment.

First, SFPP disputes CCUV's interpretation of the various FERC orders. In a December, 2005 order the FERC stated:

> there is no practical alternative to treating distributions as the equivalent of dividends and using distributions in the conventional discounted case flow (DCF) formula. As the ID states, the distributions are what investors use to determine the capitalized value of the publicly traded limited partnership interests.[47]

Secondly, irrespective of whether the cited FERC decisions actually stand for the propositions advanced by CCUV and further ignoring the fact that they reflect developments well beyond the test period at issue in A. 03-02-027, they have no bearing on the issue of SFPP's TY 2003 cost of equity given that the record in A. 03-02-027 shows that distributions considered by SFPP's witness in applying the DCF model did not involve a return of capital. The FERC cases are simply inapposite to the matter at hand.

CCUV is flatly mistaken when it asserts that Professor Williamson, SFPP's witness, conceded that the limited partnership distributions included in his analysis reflect some element of return of capital to the limited partners.[48] On the page of Exhibit 103A referenced by CCUV as reflecting Professor Williamson's purported concession as well as on the next page there is clear demonstration that there has not been a return of capital. The evidence shows exactly the opposite: The capital of the limited partners has increased! What is going on with the proxy companies in Professor Williamson's DCF study is an increase in book value, not a reduction.

While CCUV claims that it is a simple matter to illustrate that rate base and

[47] *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 77 n. 104.
[48] CCUV Initial Brief at 43.

earnings per unit will decline over time, it is significant that despite the alleged simplicity of such proof CCUV has provided none. On the other hand, SFPP's witness demonstrated that the proxy MLPs have achieved significant growth while distributions have exceeded earnings per unit. By contrast, CCUV's efforts to demonstrate that MLP distributions must reflect a return of investment, in addition to a return on investment, are based on nothing more than the hypothetical assumption that any distribution in excess of earnings per unit must necessarily reflect a decrease in the unit holder's capital investment. In contrast to CCUV's speculative reasoning, SFPP provided factual evidence demonstrating that the unit holders' capital in MLPs increased while distributions were in excess of earnings.[49]

CCUV's critique of SFPP's recommended return on equity is without merit, including CCUV's assertions that subsequent FERC determinations have somehow discredited SFPP's analysis. As for CCUV's recommended return on equity, it reflects a fundamental misapplication of the DCF model in its reliance on income rather than cash flow; and it must be ignored on that basis alone. CCUV's fallback position of using California electric utilities as a proxy group for establishing SFPP's return on equity – an implicit concession of the deficiency of its manufactured DCF alternative – is on its face an unreasonable "apples v. oranges" comparison. Consequently, the Commission should adopt SFPP's recommendation of a 15.86% as a reasonable TY 2003 return on equity.

(c) SFPP's allocation of KMEP overhead to SFPP's California jurisdictional operation is reasonable.

CCUV's challenge to SFPP's proposed allocation of overhead cost under the Massachusetts formula ("Mass Formula") is disingenuous. Under the heading, "Summary of CCUV Initial Brief," a brief that was filed on January 30, 2004, CCUV cites extra-record

[49] Ex. 103A; Williamson, Attachment JPW-4.

information from a subsequent FERC proceeding involving different costs and time periods well beyond the test year period at issue in A. 03-02-027 as ostensible validation of CCUV's cost-allocation recommendation in A. 03-02-027.[50] The reference is as improper as it is irrelevant and should be ignored.

Equally inappropriate is CCUV's argument that SFPP did not justify the exclusion of KMEP's natural gas pipeline company subsidiaries from the Mass Formula allocation. The evidence demonstrates that there was no reason to include such entities for purposes of allocating KMEP's corporate overhead among its various subsidiaries given that the natural gas assets are operated by KMEP's parent, Kinder Morgan, Inc. ("KMI") under operating agreements which call for KMEP to be charged a management fee.[51] No corporate overhead of KMEP is properly allocated to its natural gas subsidiaries since KMEP provides no G&A services to these subsidiaries. G&A services are provided to KMEP's natural gas subsidiaries by KMI – not KMEP – and such costs are directly assigned to the natural gas subsidiaries. Notwithstanding CCUV's entirely speculative and unsupported assumption that KMEP must be providing some kind of overhead support, there simply are no KMEP overhead costs to be allocated to its natural gas subsidiaries. Consequently, it would be irrational, as well as contrary to the evidence of record, to include the natural gas subsidiaries in the Mass Formula allocation as CCUV suggests. CCUV's acknowledgment that its witness included the natural gas subsidiaries in his Mass Formula allocation constitutes a clear admission of error.

At hearing in A. 03-02-027, CCUV provided no substantive grounds for disputing SFPP's Mass Formula allocation. Instead, CCUV merely complained that it had did not have

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[50] CCUV Initial Brief at 59.

[51] CCUV compounds its irrational argument by suggesting that an organization chart, rather than the operating agreement between KMEP and KMEP, demonstrates not only that KMEP owns the natural gas

(footnote continued)

ample time to review the workpapers underlying SFPP's proposed cost allocation. Consequently, CCUV's challenge to the legitimacy of SFPP's cost allocation rests solely on its proposal to remove PPAs from some, but not all, of the entities included in the Mass Formula.

CCUV's proposal itself is internally inconsistent given its failure to adjust the PAA for all entities in the Mass Formula. Of course, in a self-serving attempt to skew the allocation of costs away from SFPP's California jurisdictional operations, CCUV only removed PAA's for the regulated entities. To counter this significant failing, CCUV – on the fly – then simply suggested that the adjustment to remove PAA's is not necessary for entities that are not regulated. It is this bizarre suggestion, however, that actually emphasizes the spurious nature of CCUV's position. Specifically, as SFPP's testimony indicated, the objective of allocating overhead costs is to track the management services that are provided to the subsidiary entities and the represented costs. The underlying principle of FERC's Massachusetts allocation model assigns overhead costs based on the respective values of each of the applicable entities. CCUV's attempt to justify their PAA adjustment applicable only to regulated companies implies that non-regulatory entities simply require more management oversight – when indeed the exact opposite could be true due to regulatory compliance requirements.

CCUV is somewhat less than forthcoming in its arguments contending that FERC has ordered the removal of PAA's in applying the Mass Formula.[52] CCUV ignores the rather pertinent fact that FERC granted rehearing (Feb 2006 Order) as to its ruling in the December 2005 Order directing SFPP to remove all PAA's from the regulated subsidiaries of KMEP -- on rehearing SFPP was permitted to remove write-ups from purchases of non-regulated KMEP

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subsidiaries but further that KMEP is providing corporate support to its natural gas subsidiaries.
[52] CCUV Initial Brief at 63-64.

subsidiaries as well. In that context, CCUV's testimony in A. 03-02-027 which removes PAA's only for regulated entities is deficient if one were to evaluate its consistency with subsequent FERC actions.

With regard to CCUV's claim that KMEP's gas pipeline subsidiaries should be included in the Mass Formula allocation in light of referenced FERC decisions, CCUV seeks to marginalize the fact that SFPP was granted these exclusions on rehearing in the FERC February, 2006 order. Nor does CCUV inform the Commission that the subsequent ALJ initial decision purporting to again include the gas subsidiaries in the cost allocation formula has no force of law since it has been excepted to and that the February 2006 FERC order excluding the gas subsidiaries represents the FERC's current posture on that issue.

Finally, whatever the FERC may or may not have done in December, 2005 with respect to SFPP's Mass Formula allocation, it is quite clear that the evidence of record upon which the FERC based whatever conclusions it reached is entirely different from the record before the Commission in A. 03-02-027. The costs at issue before the FERC are obviously different costs incurred during different time periods than the KMEP overhead costs at issue for purposes of this Commission's determination of a TY 2003 cost of service for SFPP. Even more tenuous in its connection to the matter at hand is CCUV's reliance on a preliminary determination of a FERC ALJ to exclude 17 KMEP subsidiaries from the Mass Formula allocation pool based upon an alleged failure by SFPP to meet the so-called "marginal benefit" test. Aside from being all but unintelligible, CCUV's argument fails to square the claim that various KMEP subsidiaries need to be excluded from the Mass Formula allocation with CCUV's acknowledgment that its own testimony in A. 03-02-027 incorporated all of KMEP's subsidiaries

in its Mass Formula allocation.[53]

(d) SFPP's allocation of overhead costs between carrier and non-carrier operations is reasonable.

CCUV's recommendation to selectively remove PAA's from the K/N Formula for purposes of allocating costs between carrier and non-carrier operations is as cynical as it is illogical. It is also inconsistent with current FERC policy requiring uniform treatment of PAA's for regulated and non-regulated entities. It is quite true that Commission policy does disfavor inclusion of PAA's in rate base; and, accordingly, SFPP has not included any PAA's in SFPP's TY 2003 rate base. The policy, however, has never been extended to apply to, much less exclude, use of PAA's, which reflect the actual acquisition price of an asset, as a factor in allocating common overhead costs among entities who directly benefit from such overhead services.

CCUV's recommendation is nothing more than a self-serving ploy to artificially shift overhead costs from regulated entities to non-regulated entities in order to improperly depress SFPP's cost of service. In recommending the selective removal of PAA's from the K/N allocation formula., CCUV ignores the fundamental purpose of the allocation formula, which is to ensure that overhead costs are fairly distributed among all operations that benefit from their incurrence. SFPP's financially reported gross property values for both carrier and non-carrier assets, used in the K/N Allocation Formula, reflect the value that KMEP paid for all of SFPP's assets and thus reflect the value that management gives to the various assets. These amounts, which include PAA's, are more accurate for use in determining accountability for overhead services than using original cost values. The original cost values, which CCUV recommends, say nothing about the relative value that management places on the assets, which is the entire

[53] CCUV Initial Brief at 64.

purpose for using a gross property factor in allocating overhead costs.[54]

A simple hypothetical reveals the illogic of CCUV's recommendation. Assume that Company X purchases two identical pipeline systems for $ 1million each, one that is a regulated, common carrier with an original cost base of $500, 000 and one that is a unregulated proprietary pipeline. Further, assume that Company X provides corporate overhead support to both entities totaling $50,000 annually. Under SFPP's application of the K/N Formula, $25, 000 in overhead costs would be allocated to each pipeline. Under CCUV's proposal to exclude PAA's relating to acquisition of regulated entities from the K/N Formula, $12, 500 in overhead would be allocated to the common carrier pipeline while $37,500 would be allocated to the non-jurisdictional operations. Such a result would be ridiculous on its face.

The concerns expressed by CCUV regarding the alleged deficiencies of SFPP's allocations are completely without merit. CCUV admits that they have not reviewed all the data. Furthermore, the proposed elimination of the purchase accounting adjustments has no rational basis and improperly skews the overhead allocations. For these reasons, the adjustments to SFPP's expense allocations proposed by the CCUV should be rejected entirely.

(e) SFPP's TY 2003 estimates of fuel and power expenses and throughput volume are reasonable.

While CCUV did not address test year fuel and power expenses and throughput volumes in its initial brief, SFPP will now address anticipated CCUV criticism of SFPP's estimates in this regard. CCUV seeks to penalize SFPP with its recommendation to use of 2002 recorded fuel and power expenses in SFPP's Test year 2003 cost of service. Of course, CCUV's reliance on recorded data as the basis for a test year <u>forecast</u> of anticipated power expenses is quite clearly contrary to principles of test year ratemaking.. By contrast, SFPP's fuel and power

[54] *Id.* at 25).

expense recommendation relies on actual 2002 expenses, adjusted to reflect the effects of known increases in electric costs starting January 1, 2003 (i.e. a 2.7 cents/kWh charge imposed by PG&E upon direct access customers like SFPP).

As ostensible justification for its proposed penalty, CCUV has previously argued that SFPP did not present evidence supporting its adjustments and CCUC therefore used unadjusted 2002 actual fuel & power costs for a 2003 test year. Yet, CCUV itself frequently referred to the very evidence that supports SFPP's 2003 test year fuel and power expense adjustments.

First, during cross-examination, CCUV's' witness stated that he was familiar with the Commission's decision in November 2002 imposing a 2.7 cent/kWh surcharge on direct access customers effective January 1, 2003 (for PG&E customers).[55] Secondly, it is apparent that CCUV has reviewed SFPP's power invoices. Finally, SFPP provided an analysis that compared actual 2003 (annualized) fuel and power costs to SFPP's proposed 2003 test year costs. This comparison, included as Attachment B to Exhibit 105A, demonstrates that SFPP's test year fuel and power adjustments are reasonable.

CCUV's anticipated claim that they have not been presented with clear and convincing evidence in support of SFPP's proposed adjustment is obviously without merit, and the recommendation to use recorded 2002 fuel and power expense for test year purposes is not reasonable and should be rejected. Conversely, there can be little doubt about the reasonableness of SFPP's recommended fuel and expense adjustment, and it should be adopted.

In previous challenges to SFPP's TY 2003 throughput estimates, CCUV has wrongly claims that SFPP adjusted all fuel types (gasoline, jet fuel, and diesel) for the mandated

[55] See Tr. Vol. 4; O'Loughlin at 461.

transition from MTBE to ethanol. In fact, SFPP appropriately applied the test year ethanol adjustment only to gasoline volumes

CCUC further claimed that a California Energy Commission ("CEC") report, which projects an average annual 1.8 percent increase in demand for gasoline and gas additives (e.g., MTBE or ethanol) through 2010, contradicts SFPP's testimony that test year 2003 volumes will decrease. As demonstrated by SFPP rebuttal testimony, CCUV's witness inappropriately used the data included in the CEC report, and correspondingly the results of his analysis are flawed.

First, CCUV's witness selectively relied upon forecasted 2010 data when more relevant 2003 data also existed in the same report. Using forecasted 2003 data results in annual growth for demand in gasoline and gas additives of **negative** 0.04 percent. Secondly, the data relied upon by CCUV does not account for the mandated transition from MTBE to ethanol, which would further reduce the projection for volumes capable of being transported through a pipeline in test year 2003. Notably, the CEC report projects total demand growth in 2003 of 0.7 percent for total fuel (gasoline and gas additives, jet fuel, and diesel), which is very close to the comparable 0.6 growth factor used in SFPP's test year volume calculation.[56] Used appropriately, the CEC report data confirms the reasonableness of SFPP's test year volumes.

(f) SFPP's TY 2003 adjustments for DR&R and Oil Losses & Shortages are reasonable.

CCUV has admitted that there is a "dramatic difference" in the second half of 2002 relative to the first half of 2002 with respect to SFPP's tracking of oil losses and gains, which "dramatic difference" is expected to be reflected in future results as indicated by Ex.

[56] Thomas A. Turner Rebuttal Testimony, p. 26.

105A, Attachment A showing 2003 is trending the same as the last half of 2002.[57] The record evidence supports SFPP's test year adjustment for oil gains and losses.

In its initial brief, CCUV did not address SFPP's recommended inclusion of a dismantlement, removal and restoration ("DR&R") provision in SFPP's cost of service. SFPP herein responds to anticipated challenges by CCUV to the recommended DR&R treatment that have been previously expressed by CCUV.

CCUV has, in the past, claimed that FERC cases cited by SFPP in support of the proposed DR&R adjustment are readily distinguishable. By "distinguishable," CCUV argues that it is more likely that the economic life of the pipelines cited by SFPP's witness can be determined than the economic life of SFPP. CCUV specifically discussed one of the pipeline cases cited by SFPP's witness, Kuparuk Transportation Company ("Kuparuk"). Started in 1984, Kuparuk serves the second largest oil field in North America. Kuparuk's economic life very well may be different that SFPP's economic life, but determining Kuparuk's economic life is not less subjective. Kuparuk faces its own set of risks. The recent discovery of an additional 35 million barrels of recoverable reserves that will be processed through existing Kuparuk field facilities was not known with any level of precision when Kuparuk's DR&R provision was ruled reasonable over a dozen years ago.

SFPP faces its own unique set of risks that may force the ultimate shut down of portions of SFPP operations. These risks include (1) removal or shutdown of refineries in origin market, (2) alternative supply sources (refinery built in destination market), (3) major ROW issue on short haul pipeline, (4) major environmental issues, (5) and alternative energy types that

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[57] See CCUV Brief (Jan. 30, 2004) at 44, fn. 13 which refers to a "10% change in the space of only six months" while ignoring the fact that VUC's recommended $4.5 million adjustment is 32% higher than the Aug `03 YTD annualized amount of $3.4 million – a far greater departure from reality than SFPP's

(footnote continued)

cannot be transported by pipeline, such as ethanol.

SFPP readily admits that assessing the economic life of a pipeline operation, as well as other regulatory factors, is subjective. The subjectivity of this analysis is precisely why the FERC has said that a "wait-and-see" approach is unreasonable and cannot be adopted.[58] SFPP's DR&R calculation is based on the system-wide remaining life which is determined by depreciation rates approved by the FERC, which SFPP believes is the most reasonable proxy for the ultimate termination of SFPP services.

CCUV has previously complained that SFPP's witness inconsistently treated DR&R costs and reversed position without explanation, allegedly ignoring the fact that there are no (current) cash expenditures associated with DR&R. This erroneous claim is unfounded and is based upon faulty logic. DR&R is simply different than environmental remediation or litigation costs, and CCUV's "one size fits all" proposition, regardless of the circumstances or type of expense or provision, simply does not "fit."

CCUV's own witness confirmed that DR&R costs should be paid for by the shippers.[59] Nevertheless, CCUV has proposed that SFPP only include cash expenditures associated with its DR&R provision in cost of service which , if adopted, would mean that SFPP would never have the opportunity to recover DR&R costs from its shippers—cash expenditures will not occur until after shippers have stopped using (and paying for the use of) a pipeline segment. As discussed in Exhibit 105A, regulatory precedent[60] dictates that a DR&R provision be established to compensate pipeline companies for the estimated **future costs** associated with

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proposed adjustment.

[58] See Endicott Pipeline Company, 55 FERC ¶ 63,028, at p. 65,162 (1991).

[59] See Tr. Vol. 4; O'Loughlin at 476.

[60] See e.g., Enbridge Pipelines (KPC), 102 FERC ¶ 61,310 (2003); Kuparuk Transportation Co., 55 FERC ¶ 61,122 (1991); Endicott Pipeline Company, 55 FERC ¶ 63,028 (1991); White Shoal Pipeline Corp., 38 FERC ¶ 62,287 (1987).

the retirement of its facilities—future costs that need to be recovered in existing tariff rates.

(6) Proper Treatment of Watson Station/Sepulveda Rates

According to existing Commission precedent and policy, there is no requirement that rates for Watson Station and Sepulveda be cost-based. Indeed, the uncontradicted evidence of record in C. 97-04-025 demonstrates that Watson Station and Sepulveda services were provided to oil company shippers by SFPP as an accommodation. Furthermore, to the extent that the oil companies believe the rate for either Watson Station or Sepulveda to be excessive, there are viable, economic alternatives available to them. They simply are not "captive customers" of SFPP. Given the oil companies' size and sophistication as well as their many economically viable options for moving their refined products to market, neither Watson Station nor Sepulveda can remotely be described as monopoly services. The oil companies cannot deny that they have alternatives to use of SFPP's Watson Station and Sepulveda facilities. Consequently, there simply is no record evidence in C. 97-04-025 that supports the imposition of cost-based rates.

It is noteworthy that nothing in Resolution O-0043, which prompted the filing of A. 03-02-027, suggests that cost-based rates are appropriate for Watson Station and Sepulveda. While directing SFPP to provide a cost-based showing regarding Watson Station and Sepulveda, the Commission expressly indicated that, in requesting such cost-based information, it was not making any judgment whether SFPP's rates should be market-based or cost-based. The Commission specifically noted that a cost of service analysis would not necessarily resolve the issue of whether SFPP should establish separate charges for Watson Station and Sepulveda but instead was intended only to provide the current rate of return earned in the California

jurisdiction.[61]

. The Commission is free to determine that SFPP's initial tariff rates for Watson Station and Sepulveda "may be based upon market rates, rather than traditional cost of service ratemaking..."[62] SFPP's Concurrent Opening Brief reflects an extensive discussion of the reasons why cost-based ratemaking is inappropriate for Watson Station and Sepulveda, along with references to the record evidence demonstrating that full breadth of economically viable alternatives to Watson Station and Sepulveda that are available to the oil companies.[63] Only SFPP provided a detailed and sophisticated "market power" examination with respect to both Watson Station and Sepulveda. CCUV presented no evidence contesting SFPP's expert's conclusion regarding SFPP's absence of market power with respect to Wastson Station and Sepulvea services. Nor is there any countervailing evidence in the record that disputes the availability of economically viable alternatives to Watson Station and Sepulveda..

Any attempts by protesting shippers to rely on the FERC's disposition of Sepulveda "market power" issues or to rely on FERC settlement of Watson Station issues are misplaced. It is necessary to recognize that the standards under which the Commission evaluates the reasonableness of SFPP's rates for intrastate Watson Station and Sepulveda services are substantially different from those applied at the FERC. Just as importantly, the Commission must resolve the question of Watson Station and Sepulveda rates on the basis of the record before it. Whatever the basis for FERC's determination with respect to Sepulveda, the Commission has the constitutional and statutory duty to evaluate the record in C. 97-04-025, consistent with California law, and to reach an independent conclusion whether there is any

[61] Resolution O-0043 at 8.
[62] 66 CPUC2d 28, at 31.
[63] SFPP Concurrent Opening Brief at 73-89.

justification to require a cost-based rate for Sepulveda. Similarly, irrespective of the factors that gave rise to a FERC settlement of the Watson Station issues, a settlement proposal that is not even part of the record or properly before the Commission, the Commission must discharge its duty to independently evaluate the need for establishment of a cost-based rate for Watson Station based upon the evidence before it.

In that regard, the evidence of record in C. 97-04-025 unequivocally demonstrates the following: (1) SFPP's principal customers are sophisticated oil producers; (2) SFPP faces potential competition from new pipelines; (3) SFPP's shippers have reasonable alternatives to use of SFPP's Watson Station and Sepulveda facilities, such as shipment by truck, vessel or proprietary pipeline; and (4) SFPP's pipeline's proposed rates compare favorably to other pipeline rates. The fact that the rate of return on depreciated facilities associated with Wastson Station and Sepulveda is nominally high is not, in and of itself, a sufficient reason to impose cost-based rates. Indeed, imposition of a cost-based rate, in view of available alternatives to the oil companies would have no impact upon the cost of gasoline at the pump and would be nothing more than an unjustified economic windfall for the oil companies who are not known for sharing their largesse with the consuming public.

III. CONCLUSION

For all of the reasons set forth herein as well as in SFPP's Concurrent Opening Brief, SFPP asks that the Commission find and declare that:

(1) SFPP's collection of electricity surcharge revenues from October 24, 2002 to January 1, 2004 was reasonable;

(2) SFPP's collection of electricity surcharge revenues subsequent to January 1, 2004 is reasonable in consideration of SFPP's 2003 Test Year cost of service;

(3) SFPP's systemwide rates, including rates related t rates related to its

electricity surcharge and its Watson Station and Sepulveda facilities, for the period January 1, 2004 and beyond are reasonable in consideration of SFPP's 2003 TY cost of service;

(4) Charges for Watson Station and Sepulveda services collected by SFPP prior to January 1, 2004 are reasonable under the Commission's ratemaking policies applicable to oil pipeline corporations; and

(5) Charges for Watson Station and Sepulveda services collected by SFPP subsequent to January 1, 2004 are reasonable in the context of a 2003 TY cost of service.

Respectfully submitted this 17th day of May, 2007 at San Francisco, California.

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2539/001/X88877.v3

CERTIFICATE OF SERVICE

I, Lisa Vieland, certify that I have on this 17th day of May 2007 caused a copy of the foregoing

CONCURRENT REPLY BRIEF OF SFPP, L.P.

to be served on all known parties to C.97-04-025, C.00-04-013, A.00-03-044, A.03-02-027, A.04-11-017, A.06-01-015, A.06-08-028 and C. 06-12-031 listed on the most recently updated service list available on the California Public Utilities Commission website, via email to those listed with email and via U.S. mail to those without email service. I also caused courtesy copies to be hand-delivered as follows:

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California Public Utilities Commission
State Building, Room 5218
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ALJ Douglas M. Long
California Public Utilities Commission
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I declare under penalty of perjury that the foregoing is true and correct.

Executed this 17th day of May 2007 at San Francisco, California.

/s/ Lisa Vieland
Lisa Vieland

2539/001/X89202.v1

Service List C9704025
Last Updated 4-10-07

Related Cases: C00-04-013, A.00-03044, A.03-02-027, A.04-11-017, A.06-01-015, A.06-08-028 and C. 06-12-031

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